

GAO

Exposure Draft

July 1998

**Government Auditing
Standards**

Additional Documentation
Requirements When Assessing
Control Risk at Maximum for
Computer-Related Controls



United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

July 8, 1998

TO AUDIT OFFICIALS AND OTHERS INTERESTED IN
GOVERNMENT AUDITING STANDARDS

GAO invites your comments on the accompanying proposed changes to *Government Auditing Standards* (GAGAS), commonly known as the "yellow book." These changes add a field work standard for financial statement audits to require additional documentation when control risk for computer-related controls is assessed at maximum. This letter describes the process followed in revising the standards, discusses the proposed changes, outlines the format of this exposure draft, and requests comments from interested parties on these proposed revisions.

To help ensure that the standards continue to meet the needs of the audit community and the public it serves, the Comptroller General of the United States appointed the Advisory Council on Government Auditing Standards to review the standards and recommend necessary changes. The Council includes experts in financial and performance auditing drawn from all levels of government, private enterprise, public accounting, and academia. In February 1997, the Advisory Council on Government Auditing Standards endorsed a revised approach of issuing individual standards issue-by-issue as the Council reaches consensus on a particular issue, with periodic codification of the standards. This revised approach was adopted to provide more timely revision of the standards for emerging audit issues. The approach will continue the practice of seeking public comment on all draft revisions. The Council will consider those comments in making recommendations to the Comptroller General of the United States in finalizing revisions to the standards.

This exposure draft reflects the Council's recommendations to the Comptroller General regarding a new field work standard for financial statement audits prescribing additional documentation requirements for (1) the assessment of control risk at maximum for assertions significantly dependent on computer applications and (2) the basis for concluding that resulting audit procedures are designed to effectively achieve audit objectives and appropriately limit audit risk. The American Institute of Certified Public Accountants (AICPA), in issuing Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*, requires auditors to document their basis for conclusions when control risk is assessed below maximum. However, SAS No. 78 does not impose a similar requirement for assessments of control risk at maximum. This proposed standard will help ensure that auditors conducting

financial statement audits in accordance with *Government Auditing Standards* carefully consider controls related to assertions which are significantly dependent on computer applications and appropriately limit audit risk related to such assertions.

This exposure draft also presents conforming changes to GAGAS field work standards for financial statement audits to recognize, where applicable, the effect of SAS No. 78 on GAGAS for internal control. These changes principally affect sections 4.21 through 4.33 and consist of updating terminology to conform with SAS No. 78 and deleting guidance that is addressed in SAS No. 78, which was issued after the 1994 revision of the yellow book.

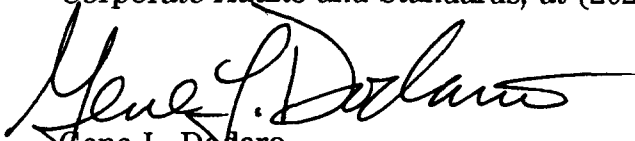
In the exposure draft, the proposed changes are indicated by highlighting proposed language and striking out the proposed deleted language. The revision will be effective for financial statement audits of periods ending on or after September 15, 1999.

The exposure draft is being sent to financial management and audit officials at all levels of government, the public accounting profession, academia, professional organizations, and public interest groups. Your comments on the proposed changes are encouraged. To facilitate review of the exposure draft, it is located on the Internet on GAO's Home Page (www.gao.gov). Additional copies of these proposed standards can be obtained from the U. S. General Accounting Office, Room 1100, 700 4th Street, NW, Washington, D.C. 20548, or by calling (202) 512-6000.

To facilitate analysis of your comments, it would be helpful if you sent them both in writing and on diskette (in ASCII format). To ensure that your comments are considered in preparing the final revised standard, please submit them by September 30, 1998, to:

Government Auditing Standards Comments
Computer-Related Controls
U.S. General Accounting Office
Room 5089 (AIMD)
441 G Street, NW
Washington, DC 20548

If you need additional information, please call Robert W. Gramling, Director, Corporate Audits and Standards, at (202) 512-9406.


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FIELD WORK STANDARDS FOR FINANCIAL AUDITS

PURPOSE

- 4.1 This chapter prescribes standards of field work for financial audits, which include financial statement audits and financial related audits.

RELATION TO AICPA STANDARDS

- 4.2 For financial statement audits, generally accepted government auditing standards (GAGAS) incorporate the American Institute of Certified Public Accountants' (AICPA) three generally accepted standards of field work, which are:
- a. The work is to be adequately planned and assistants, if any, are to be properly supervised.
 - b. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
 - c. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.
- 4.3 The AICPA has issued statements on auditing standards (SAS) that interpret its standards of field work (including a SAS on compliance auditing).¹ This chapter incorporates these SASs and prescribes additional standards on
- a. audit follow-up (see paragraphs 4.7, 4.10, and 4.11),
 - b. noncompliance other than illegal acts (see paragraphs 4.13 and 4.18 through 4.20), and
 - c. ~~documentation of the assessment of control risk for assertions significantly dependent upon computer applications (see paragraphs 4.21.1 through 4.21.4), and~~
 - e. ~~d.~~ working papers. (See paragraphs 4.35 through 4.38.)
- 4.4 This chapter also presents guidance on three other key aspects of financial statement audits:

¹GAGAS incorporate any new AICPA standards relevant to financial statement audits unless the General Accounting Office (GAO) excludes them by formal announcement.

- a. materiality (see paragraphs 4.8 and 4.9),
 - b. irregularities~~fraud~~ and illegal acts (see paragraphs 4.14 through 4.17), and
 - c. internal controls. (See paragraphs 4.21~~22~~ through 4.33.)
- 4.5 This chapter concludes by explaining which standards auditors should follow in performing financial related audits.

INTERNAL CONTROLS

4.21 AICPA standards and GAGAS require the following:

Auditors should obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed.

4.21.1 The additional internal control standard for financial statement audits is

Auditors should document in the working papers in sufficient detail (1) the basis for assessing control risk at the maximum level for assertions related to account balances, transaction classes, and disclosure components of financial statements that are significantly dependent upon computer applications, and (2) the basis for concluding that the resulting audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.

4.21.2 AICPA standards and GAGAS require that, in all audits, the auditor obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand (1) the design of controls relevant to an audit of financial statements and whether (2) the controls have been placed in operation. This understanding should include a consideration of the methods an entity uses to process accounting information because such methods influence the design of internal control. The extent to which computer processing is used in significant accounting applications,² as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in obtaining an understanding of an entity's computer processing, the auditor should consider, among other things, such matters as

- a. the extent to which computer processing is used in each significant accounting application;**

²Significant accounting applications are those which relate to accounting information that can materially affect the financial statements the auditor is auditing.

- b. the complexity of the entity's computer operations;
- c. the organizational structure of the computer processing activities; and
- d. the availability, sufficiency, and competency of data, in electronic and in paper formats, to achieve audit objectives.³

4.21.3 AICPA and GAGAS standards require auditors to document their understanding of the components of an entity's internal control related to computer applications that process information used in preparing an entity's financial statements and, based on that understanding, develop a planned audit approach in sufficient detail to demonstrate its effectiveness in reducing audit risk.

4.21.4 GAGAS further require that, if the auditor assesses control risk at the maximum level for assertions related to account balances, transaction classes, and disclosure components of financial statements that are significantly dependent upon computer applications, the auditor should document the basis for that conclusion by addressing (1) ineffectiveness of the design and/or operation of the controls, or (2) the reasons why it would be inefficient to test the controls. In such circumstances, GAGAS also requires the auditor to document in the working papers the basis for concluding that the planned audit procedures would achieve audit objectives and would accordingly reduce audit risk to an acceptable level. This documentation should address in sufficient detail

- a. the rationale for determining the nature, timing, and extent of planned audit procedures;
- b. whether data produced outside of a computerized system are sufficient and competent to achieve audit objectives and reduce audit risk to an acceptable level; and
- c. the effect on the audit opinion if audit procedures are not sufficient to avoid a scope limitation or other qualification.

4.21.5 Under AICPA standards and GAGAS, the auditor should consider whether specialized skills are needed for considering the effect of computer processing on the audit, understanding internal control, or designing and performing audit procedures, including tests of internal control. If the use of a professional with specialized skills is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work, to evaluate whether the specified procedures will meet

³ Obtaining an understanding of these elements would include consideration of internal control related to security over computer-processed data.

the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

INTERNAL CONTROL GUIDANCE

4.22 In conducting financial statement audits under GAGAS, safeguarding of assets and compliance with laws and regulations are internal control objectives that are especially important in conducting financial statement audits of governmental entities or others receiving government funds. Given the public accountability for stewardship of resources, safeguarding of assets permeates control objectives and components as defined by the AICPA standards and GAGAS. Also, the operation of government programs and the related transactions that materially affect the entity's financial statements are generally governed by laws and regulations. Although GAGAS does not prescribe additional internal control standards in these areas, for financial statement audits. However, this chapter provides guidance on the following four aspects of internal controls that are important to the judgments auditors make about may find useful in assessing audit risk and about the in obtaining evidence needed to support their opinion on the financial statements: in a governmental environment.

- a. — control environment;
- b. — safeguarding controls;
- c. — controls over compliance with laws and regulations; and
- d. — control risk assessments.

Control Environment

4.23 Auditors' judgments about the control environment may influence either positively or negatively their judgments about specific control procedures. For example, evidence indicating that the control environment is ineffective may lead auditors to question the likely effectiveness of a control procedure for a particular financial statement assertion. Conversely, based on evidence indicating that the control environment is effective, auditors may decide to reduce the number of locations where they will perform auditing procedures.

4.24 Auditors' judgments about the control environment also can be affected by the results of their tests of other internal controls. If auditors obtain evidence that specific control procedures are ineffective, they may find it necessary to reevaluate their earlier conclusion about the control environment and other planning decisions they had made based on that conclusion.

~~Paragraphs 4.23 and 4.24 deleted~~

Safeguarding Controls of Assets

- 4.25 ~~As applied to financial statement audits, internal controls over safeguarding of assets~~ (safeguarding controls) constitute a process, effected by an entity's governing body, management, and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.
- 4.26 ~~Internal control over the~~ Safeguarding controls of assets relate to the prevention or timely detection of unauthorized transactions and unauthorized access to assets that could result in losses that are material to the financial statements, for example, when unauthorized expenditures or investments are made, unauthorized liabilities are incurred, inventory is stolen, or assets are converted to personal use. Such controls ~~are~~ designed to help ensure that use of and access to assets are in accordance with management's authorization. Authorization includes approval of transactions in accordance with policies and procedures established by management to safeguard assets, such as establishing and complying with requirements for extending and monitoring credit or making investment decisions, and related documentation. ~~Control over Safeguarding controls of assets is~~ not designed to protect against loss of assets arising from inefficiency or from management's operating decisions, such as incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory.
- 4.27 AICPA standards and GAGAS require auditors to obtain a sufficient understanding of internal controls to plan the audit. They also require auditors to plan the audit to provide reasonable assurance of detecting material ~~irregularities~~ fraud, including material misappropriation of assets. Because preventing or detecting material misappropriations is an objective of ~~control over safeguarding controls of assets~~, understanding ~~those~~ this type of controls can be essential to planning the audit.
- 4.28 ~~Control over Safeguarding controls of assets is~~ not limited to preventing or detecting misappropriations, however. They also help prevent or detect other material losses that could result from unauthorized acquisition, use, or disposition of assets. Such controls includes, for example, the process of assessing the risk of unauthorized acquisition, use, or disposition of assets and establishing control activities to help ensure that management directives to address the risk are carried out. Such control activities would include ~~controls to permitting~~ acquisition, use, or disposition of assets only in accordance with management's general or specific authorization, including compliance with established policies and procedures for such acquisition, use, or disposition. They would also include comparing existing assets with the related records at reasonable intervals and taking appropriate action with respect to any differences. Finally, controls over ~~the~~ safeguarding of assets against unauthorized acquisition, use, or disposition also relates to making available to management information it needs to carry out its responsibilities related to

prevention or timely detection of such unauthorized activities, as well as mechanisms to enable management to monitor the continued effective operation of such controls.

- 4.29 Understanding these ~~the control over~~ safeguarding controls ~~of assets~~ can help auditors assess the risk that financial statements could be materially misstated. For example, an understanding of an auditee's ~~safeguarding controls over the safeguarding of assets~~ can help auditors recognize risk factors such as
- a. failure to adequately monitor decentralized operations;
 - b. lack of controls over activities, such as lack of documentation for major transactions;
 - c. lack of controls over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets;
 - d. failure to develop or communicate adequate policies and procedures for security of data or assets, such as allowing unauthorized personnel to have ready access to data or assets; and
 - e. failure to investigate significant unreconciled differences between reconciliations of a control account and subsidiary records.

Controls Over Compliance With Laws and Regulations

4.29.1 Governmental entities are subject to a variety of laws and regulations that affect their financial statements and are a major factor distinguishing governmental accounting from commercial accounting. For example, such laws and regulations may address the fund structure required by law or regulation, procurement or debt limitations, or legal authority for transactions. Accordingly, compliance with such laws and regulations may have a direct and material impact on the determination of amounts in the financial statements of governmental entities. Likewise, organizations that receive government assistance, such as contractors, nonprofit organizations, and other nongovernmental organizations are also subject to regulations, contract provisions, or grant agreements that could have a direct and material effect on the financial statements. Management, of both governmental entities and others receiving governmental funds, is responsible for ensuring that the entity complies with the laws and regulations applicable to its activities. That responsibility encompasses the identification of laws and regulations and the establishment of controls designed to provide reasonable assurance that the entity complies with those laws and regulations.

- 4.30 ~~AICPA standards and GAGAS require a~~ Auditors ~~should~~ design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on

the determination of financial statement amounts. To meet that requirement, auditors should have an understanding of internal controls relevant to financial statement assertions affected by those laws and regulations. Auditors should use that understanding to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. For example, the following ~~control environment~~ factors may influence the auditors' assessment of control risk:

- a. management's awareness or lack of awareness of applicable laws and regulations,
- b. auditee policy regarding such matters as acceptable operating practices and codes of conduct, and
- c. assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.

Control Risk Assessments

~~4.31 When auditors assess control risk below the maximum for a given financial statement assertion, they reduce their need for evidence from substantive tests of that assertion. Auditors are not required to assess control risk below the maximum, but the likelihood that they will find it efficient and effective to do so increases with the size of the entities they audit and the complexity of their operations. Auditors should do the following when assessing control risk below the maximum:~~

- ~~a. identify internal controls that are relevant to a specific financial statement assertion;~~
- ~~b. perform tests that provide sufficient evidence that those controls are effective; and~~
- ~~c. document the tests of controls.~~

~~4.32 Auditors should remember the following when planning and performing tests of controls:~~

- ~~a. The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.~~
- ~~b. Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.~~
- ~~c. Inquiries alone generally will not support an assessment that control risk is below the maximum.~~

- ~~d. Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.~~
 - ~~e. Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since they last performed those tests.~~
- ~~4.33 Auditors may find it necessary to reconsider their assessments of control risk when their substantive tests detect misstatements, especially those that appear to be irregularities or due to illegal acts. As a result, they may find it necessary to modify their planned substantive tests for some or all financial statement assertions. Deficiencies in internal controls that led to those misstatements may be reportable conditions or material weaknesses, which auditors are required to report.~~

~~Paragraphs 4.31 through 4.33 deleted.~~